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IN THE

Supreme Court of the United States

HOECHST CELANESE CORPORATION,
Petitioner,

v.

FRANCHISE TAX BOARD,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of the State of California

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Brief of *Amicus Curiae* Committee On State Taxation In Support of Petition for Writ of Certiorari

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Brief of *Amicus Curiae* Committee On State Taxation In Support of Petition for Writ of Certiorari

INTEREST OF THE *AMICUS CURIAE*

The Committee On State Taxation (COST) submits this brief as *amicus curiae* in support of Petitioner in the above captioned matter.[1] COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities.

COST is a non-profit trade association that was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce. COST, which was separately incorporated on January 1, 1992, has a membership of over

[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioner and Respondent has been obtained and filed with the Clerk of the Court.

550 multistate corporations involved in interstate and international commerce. COST's members' interest in this case is both specific and general: while some members may experience extraordinary pension reversions, all members are interested in the Court's interpretation of constitutional limits on a state's ability to tax a nondomiciliary corporation's income. All of COST's member companies either do business in California or are subject to corporate income taxes in other states with statutes similar to California's.

COST submits this brief to encourage the Court to provide needed guidance in an area that affects its members. Specifically, COST hopes that the Court will clarify the distinction between capital transactions serving operational functions and those serving investment functions. *See Allied-Signal, Inc. v. Director, N.J. Div. of Tax,* 504 U.S. 768 (1992); *Container Corp. of America v. Franchise Tax Board,* 463 U.S. 159 (1983). Without such guidance, States will continue to run afoul of the constitutional limitations on States' ability to tax outside their borders. In the instant matter, the key constitutional inquiry before the Court is whether Hoechst Celanese's income from a pension reversion resulted from a capital transaction serving an operational or an investment function. The California Supreme Court, operating without sufficient guidance from this Court, determined that the income was operational after scant analysis, to the detriment of nondomiciliary taxpayers doing business in the State. By granting the Petition for Certiorari, this Court can clarify the constitutional test for when a capital transaction serves an operational versus an investment function.

SUMMARY OF THE ARGUMENT

The United States Constitution limits states' ability to tax income from outside their territorial boundaries. Generally, states may apportion a multijurisdictional taxpayer's income if the income arises from a unitary business. If the income

arises from a capital transaction outside the unitary business context, states may apportion the income if the transaction served an operational, rather than an investment, function.

This Court's guidance is needed to define more clearly when a capital transaction serves an operational or investment function. The functional test has led to confusion among academics, practitioners, and states alike. The California Supreme Court's misapplication of the test resulted in California's taxing income beyond its territorial boundaries in violation of the Constitution. Had that court applied the test properly, California would not be permitted to tax Hoechst Celanese's income from a transaction involving the reversion of excess pension funds.

ARGUMENT

I. THE CONSTITUTION LIMITS STATES' ABILITY TO TAX INCOME FROM OUTSIDE THEIR TERRITORIAL BOUNDARIES.

As a general principle, both the Commerce Clause and the Due Process Clause limit a state's ability to tax a nondomiciliary corporation's multi-state income. U.S. Const. art. I, § 8, cl. 3; amend. XIV, § 1. Consistent with these constitutional limitations, a state's ability to tax income earned by a multistate business requires a "minimal connection" between the interstate activities of the corporation and the taxing state. *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 436-437 (1980) (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-273 (1978)); *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-345 (1954). States are prohibited from taxing a nondomiciliary corporation's income, if that income is "derive[d] from 'unrelated business activity' which constitutes a 'discrete business enterprise.'" *Exxon Corp. v. Department of Revenue of Wis.*, 447 U.S. 207, 224 (1980) (quoting *Mobil Oil*, 445 U.S. at 442).

As a result of these constitutional limitations, states have adopted practical statutory rules for determining income subject to tax in each jurisdiction. States use the concept of business income to identify income that can be apportioned and taxed by each jurisdiction in which the company earns income, and the concept of nonbusiness income to identify income that is allocated to a single jurisdiction for tax purposes. These concepts have been statutorily captured in the Uniform Division of Income for Tax Purposes Act (UDITPA), which defines business and nonbusiness income.[2] While UDITPA's definitions provide a practical approach for states to identify income taxable in each jurisdiction, the definitions are statutory and by nature and application different than the constitutional rules.[3]

The present matter involved a dispute at the state court level over whether a certain type of income (gain earned on a pension reversion) should be classified as business or nonbusiness income under the UDITPA definitions, and,

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[2] California, like many states, has adopted UDITPA, which differentiates between business income, apportionable to various states, and nonbusiness income, which must be allocated to one source state. *See* 7A U.L.A. 331 (1985).

[3] In *Allied-Signal*, this Court refused to adopt the business/nonbusiness income tests of UDITPA as the equivalent of the constitutional test for the unitary business principle. *Allied-Signal,* 504 U.S. 768, 786-87 (1992). *See also ASARCO v. Idaho State Tax Comm'n,* 458 U.S. 307, 326 (1982) ("Idaho's proposal is that corporate *purpose* should define unitary business. It argues that intangible income should be considered a part of a unitary business if the intangible property . . . is 'acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business.' This definition of unitary business would destroy the concept. The business of a corporation requires that it earn money to continue operations and to provide a return on its investment capital. Consequently, *all* of its operations, including any investment made, in some sense can be said to be 'for purposes related to or contributing to the [corporation's] business' . . . When pressed to its logical limit, this conception of the 'unitary business' limitation becomes no limitation at all.").

from a constitutional perspective, whether apportioning the income runs afoul of the limits on a state's ability to subject the income of a nondomiciliary business to apportionment.

In defining the constitutional limits on states' ability to tax income, this Court has developed two separate classes of income that may be subject to apportionment. First, income earned in a unitary business is apportionable. *See Mobil Oil,* 445 U.S. at 435. Recall, "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Id.* at 439. Second, even in cases where the unitary principle is not involved, income is apportionable if it serves an operational function within the business. *Container Corp.,* 463 U.S. at 180, n.19; *Allied-Signal,* 504 U.S. at 787. The present case does not involve a question of unity but, like *Allied-Signal,* presents the second test for apportionable income.

Allied-Signal analyzed the apportionability of a taxpayer's gain realized on the sale of stock in an unrelated company. 504 U.S. at 774. Because the two entities were not unitary, the Court used the second test for determining the constitutionality of taxing income from a capital transaction. Specifically, the Court held that the transaction must serve an operational function within the business, rather than an investment function, for a nondomiciliary state to be permitted to subject the income from that transaction to apportionment. 504 U.S. at 787. In the present case, as in *Allied-Signal,* the question is not whether there was a unitary business. As a result, the operational versus investment function test is squarely presented.

II. THIS COURT'S GUIDANCE IS NEEDED TO DEFINE CONSTITUTIONAL LIMITS IN THE CONTEXT OF WHEN A CAPITAL TRANSACTION SERVES AN OPERATIONAL OR INVESTMENT FUNCTION.

Where a state is trying to tax a nondomiciliary company's income from a capital transaction, and the unitary issue is not presented, the proper constitutional inquiry is whether the transaction served an operational or investment function. In *Hoechst Celanese,* the California Supreme Court focused most of its attention on whether income from pension reversion was business income under UDITPA, answering in the affirmative. *Hoechst Celanese Corporation v. Franchise Tax Board,* 22 P.3d 324, 345 (Ca. 2001). Then, with minimal analysis, that court purported to address whether the state could constitutionally tax the income. *Id.* The court found no constitutional problem, but admitted its uncertainty in applying the operational function test, stating, "the United States Supreme Court has not clearly differentiated operational and investment functions." *Id.* Although the misapplication of the constitutional test may be understood in its reliance on this Court's lack of definition, it cannot be constitutionally tolerated.

The operational/investment function distinction originated in *Container Corp.* and was affirmed in *Allied-Signal.* In *Container Corp.,* this Court reviewed the constitutionality of California's worldwide combination tax scheme. 463 U.S. 159 (1983). Although *Container* involved a unitary business determination, the Court pointed out that "capital transactions can serve either an investment function or an operational function." 463 U.S. at 180 n.19. In *Allied-Signal* this Court further clarified the meaning of the operational versus investment function test.

Allied-Signal involved the taxability of a gain realized by Bendix Corporation on the sale of its stock in ASARCO, Inc.

504 U.S. at 773. Because the payee and payor were not engaged in the same unitary business (and in fact were completely unrelated entities), the Court clarified that the two corporations need not be unitary in order for apportionment of Bendix's gain to lie. *Id.* at 774, 787. Rather, "[w]hat is required instead is that the capital transaction [that produced the income] serve an operational rather than an investment function." *Id.* at 787, citing *Container Corp.,* 463 U.S. at 180, n.19. The distinction was further explained as the difference between a passive investment and an "integral operational" one. *Allied-Signal,* 504 U.S. at 788.

Unfortunately, beyond providing the basic words, *Allied-Signal* contains precious little guidance for taxpayers and states to determine when a capital transaction that appears to be a passive investment might serve an operational function within the business. The only example provided in *Allied-Signal* was the proper treatment of interest income earned by a corporation on "short-term deposits in a bank located in another State, if that income forms part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary relationship between the corporation and the bank." *Id.* at 787-788. The majority opinion indicated that such income would serve an operational function. *Id.* at 787-90. The instant matter provides the Court with an opportunity to instruct practitioners and state governments alike in how to apply the operational function test. *See id.* at 792-93 (O'Connor, J., dissenting) ("[t]he Court . . . leaves 'operational function' largely undefined"). The Court's own example suggests that the test is narrow, applicable only when the unitary business analysis is inappropriate.

A well-known expert in state taxation readily admits that *Allied-Signal* "is but one piece of the complex and often confusing mosaic of federal constitutional and state statutory rules governing state taxation of corporate income from intangibles." Walter Hellerstein, *State Taxation of Corporate*

Income from Intangibles: Allied-Signal and Beyond, 48 Tax L. Rev. 739, 742-43 (1993). Hellerstein's criticism originates with Justice O'Connor's dissent in *Allied-Signal* ("[a]ny distinction between short-term and long-term investments cannot be of constitutional dimension"). 504 U.S. at 792-93 (O'Connor, J., dissenting). Professor Hellerstein further addresses the short-term/long-term distinction:

> Clearly, it makes no difference from a constitutional standpoint whether, for example, a corporation's working capital takes the form of 30-year Treasury bills or 30-day commercial paper. The income from those investments would be apportionable in any event. Nor should it make any difference whether a corporation's portfolio of investments held to finance future business expansion takes the form of long-term or short-term investments. The income from those investments would not serve an operational function in either case.

Hellerstein, *supra* at 798; *see Sperry & Hutchinson Co. v. Department of Revenue,* 527 P.2d 729, 730-31 (Or. 1974) (short-term and long-term investments were held equally not part of the taxpayer's unitary business and not apportionable). Professor Hellerstein continues, "[w]hile it may be true as a practical matter that intangible assets used for working capital are generally short-term, highly liquid investments, whereas intangible assets held in anticipation of future business opportunities tend to be of longer duration, there is nothing about the term of the investment that in itself makes it operational or nonoperational." *Id.*

Other scholars agree that an explanation of the constitutional principles governing state taxation of multistate businesses is desperately needed. *See* David F. Shores, *State Taxation of Interstate Commerce: Quill, Allied-Signal and a Proposal,* 72 Neb. L. Rev. 682, 683 (1993). Professor Shores would prefer that the Court "disentangle due process and commerce clause constraints on state taxation of interstate commerce." Shores, *supra* at 683. At the very least, it is

agreed that standards in this area need clarification. *See* John Mackay Metzger, *Unitary Taxation in New Jersey,* 28 Seton Hall L. Rev. 162, 175-76 (1997) (administrative and practical problems in distinguishing operational from investment income need to be addressed); Ferdinand P. Schoettle, *Big Bucks, Cloudy Thinking: Constitutional Challenges to State Taxes — Illumination from the GATT,* 19 Va. Tax Rev. 277, 281-83 (1999) (scholars have lamented the lack of a "grand design" in Commerce Clause tax cases). *Hoechst Celanese* presents this Court with an opportunity to provide desperately needed guidance.

III. THE CALIFORNIA SUPREME COURT'S MISAPPLICATION OF THE OPERATIONAL FUNCTION TEST RESULTED IN CALIFORNIA'S TAXING INCOME BEYOND ITS TERRITORIAL BOUNDARIES, IN VIOLATION OF THE CONSTITUTION.

Scarcity of guidance on the operational/investment function test notwithstanding, the *Hoechst Celanese* court's analysis on the constitutionality of taxing pension reversion income was wholly inadequate. While the court discussed the UDITPA issue in great detail, its inquiry into the constitutional issue was cursory. *See Hoechst Celanese,* 22 P.3d at 344-45. Whether the pension reversion income fit California's tax statutes does not address the constitutionality of the State's attempt to tax the income. The underlying issue of constitutionality was and remains key to the case.

The parties below disputed whether the test for business income under UDITPA contains a transactional test, a functional test, or both.[4] The California Supreme Court ultimately

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[4] UDITPA § 1(a) defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute

concluded that UDITPA contains both a transactional and a functional test for business income. 22 P.3d at 335-36. After extensive dissection of the statutory language, the California court held that while pension reversion income did not satisfy the transactional test, it was business income, subject to apportionment, under the functional test.[5] *Id.* at 337.

The California Supreme Court then turned to the constitutional issue and, without sufficient analysis, incorrectly concluded that apportioning the pension reversion income passed constitutional muster. The court recognized that "'a State may not tax value earned outside its borders,'" and cited other authorities in an effort to lay the proper groundwork for its constitutional analysis. *See Hoechst Celanese,* 22 P.3d at 344, *quoting ASARCO, Inc. v. Idaho State Tax Comm'n,* 458 U.S. 307, 315 (1982), *and citing Miller Bros. Co. v. Maryland,* 347 U.S. 340, 344-45 (1954) ("[T]here must be 'some definite link, some minimum connection, between a

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integral parts of the taxpayer's regular trade or business operations." *Id.* Nonbusiness income is defined as "all income other than business income." UDITPA § 1(e). In several states, the UDITPA business income definition has been interpreted as incorporating two alternative tests for determining whether income is business income: the transactional test and the functional test. *See* 1 John C. Healy, *2001 Multistate Corporate Tax Guide: Corporate Income Tax,* at I-659 to I-662 (2001). The transactional test requires that income be considered business income if it arises from transactions and activities in the regular course of the taxpayer's trade or business. UDITPA § 1(a). Under the functional test, if the acquisition, management, and disposition of the asset generating the income constitutes an integral part of the taxpayer's regular trade or business operations, the income will be considered apportionable business income. *Id.*

[5] *Cf. Union Carbide Corp. v. Offerman,* 526 S.E.2d 167 (N.C. 2000) (applying the functional test, but concluding that pension reversion income was not business income.) While the *Union Carbide* court failed to expressly reach the constitutional issue, it is not improbable that its analysis considered the possibility that reaching a different conclusion on the statutory interpretation issue would run afoul of constitutional limits.

state and the person, property or transaction it seeks to tax'") *and Mobil Oil,* 445 U.S. at 439 ("Corporate income 'earned in the course of activities unrelated to [corporate activities in the taxing] State' is not includible in any apportionment formula"). After laying the groundwork, the court took a wrong turn, confusing the concepts and the underlying facts from its various cited authorities. The result was the conclusion that California could apportion the pension reversion income of Hoechst Celanese consistent with the Constitution. Such a conclusion is seriously misguided.

In *Hoechst Celanese,* the court mingled the test for whether a business is unitary with the test for whether a capital transaction serves an operational function. In a confused attempt to navigate the constitutional issue, the court asserted,

> Although the United States Supreme Court has not clearly differentiated operational and investment functions, it has stated that an asset serves an operational function if it helps the taxpayer "make better use . . . of [its] existing business-related resources."

Hoechst Celanese, 22 P.3d at 345, *citing Container Corp.,* 463 U.S. at 178. That statement misapplied *Container Corp.,* where the issue was whether two corporations in the same line of business were unitary. The complete quote from *Container* does not address the operational versus investment function test. Instead it further defines unitary analysis as follows:

> When a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to make better use—either through economies of scale or through operational integration or sharing of expertise—of the parent's existing business-related resources.

Container Corp., 463 U.S. at 178. In *Hoechst Celanese,* the issue was not whether two corporations were unitary, but

rather, whether income from a pension reversion was operationally related to the business. 22 P.3d at 328-330. *Container's* "better use" standard for unitary analysis was thus inappropriately applied.

Further, in support of its conclusion that the state tax was constitutional, the California Supreme Court erroneously focused only on the factors that determine whether gains are statutorily business income. Specifically, the court enumerated that Hoechst funded its retirement plan with apportionable business income; it controlled the plan by selecting its managers; and the plan's purpose was to retain and attract employees. 22 P.3d at 345. These factors were first cited to support the court's conclusion that the reversion produced business income under UDITPA's functional test. *Id.* at 342-43. Then the court cited the same factors in support of its finding that imposition of tax on the pension reversion passed constitutional muster. The substitution of UDITPA standards for constitutional standards reveals, at best, a lack of comprehension of the difference between the two. At worst, it flouts this Court's previous refusal to equate constitutional principles with the inflexible statutory language of UDITPA. *See Allied-Signal,* 504 U.S. at 786-87.

The proper inquiry under *Container Corp.* and *Allied-Signal* is whether the capital transaction that gave rise to the income serves an operational or investment function.[6]

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[6] In a conceptual error which compounded the confusion of tests, the *Hoechst Celanese* court focused solely on the *asset*, ignoring the nature of the *capital transaction*. The court focused on whether the asset served an operational function, stating that "only income from assets that 'serve an operational rather than an investment function' are apportionable to a state for tax purposes." 22 P.3d at 345, *citing Allied-Signal*, 504 U.S. at 787. The court then applied the wrong standard: "Here, the income-producing *asset*—the pension plan and trust—undoubtedly *served* an operational function for Hoechst." 22 P.3d at 345 (emphasis added). In *Allied-Signal*, "serve" modifies "capital transaction." *Allied-Signal,* 504 U.S. at 787. It is unclear then why the *Hoechst Celanese* court focuses on the

Allied-Signal, 504 U.S. at 787. If the correct standard were applied with due care, California would not be allowed to tax the pension reversion income. The capital transaction at issue for Hoechst was removing surplus assets from an ERISA-qualified pension trust. 22 P.3d at 328-30. The recapture was a "once-in-a-lifetime corporate occurrence," performed to prevent the assets from being used against the company in a hostile takeover. *Id.* at 337, 329. Achieving its goal meant accessing funds that were, by law, in trust. Clearly, the nature of the transaction was not operationally related to the taxpayer's business in California. Further, Hoechst did not own or hold legal title to the assets of the trust. *Id.* at 328. During the existence of the retirement plan, "none of the pension plan assets, including any contributions or capital gains, were taxable as Hoechst's income." *Id.* at 329. Most central to the constitutional analysis, the surplus in the trust was attributable to "years of wise *investments.*" *Id.* (emphasis added).

The facts illustrate that the capital transaction at issue performed an investment function: the cashing in of investment assets. Moreover, the instant facts are analogous to the facts in *Allied-Signal,* and indeed weigh even more strongly against apportionment. In *Allied-Signal,* the taxpayer disposed of a minority stock interest in another company and realized a gain. 504 U.S at 773-74. There was no question that the taxpayer had all indicia of ownership. By contrast, Hoechst Celanese was not the legal owner of the pension trust that gave rise to the reversion income. 22 P.3d at 328. Both transactions served investment functions; neither properly yielded apportionable income.

This result supports the principle that "in the case of a tax on an activity, there must be a connection to the activity itself." *See Allied-Signal,* 504 U.S. at 778. In *Allied-Signal,*

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asset serving an operational function, ignoring the nature of the capital transaction.

the activity was corporate investment in another company. In the instant matter, the activity is utilizing permissible means to yield the results of superior investments within a funded pension. The taxpayer is a Delaware corporation with a principal place of business in New Jersey and a commercial domicile in New York. 22 P.3d at 328. Under the constitutional framework, and these facts, California does not have sufficient connection to this investment activity to apportion the income therefrom in California.

The California Supreme Court's faulty analysis in *Hoechst Celanese* highlights the need for this Court to clarify the test for determining whether a capital transaction serves an operational function or an investment function. High-level guidance is required to protect taxpayers from the long arm of states reaching to tax extraterritorial income. *See Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000) (states may not tax extraterritorial values through unreasonable expense disallowance). Again, California is attempting to tax income that lacks the requisite connections with the state as required under the Constitution.

CONCLUSION

For the reasons stated above, COST respectfully requests the Court to accept this case for review.

Respectfully submitted,

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